The Transpacific Imbalance: What can be done about it?

Yung Chul Park
Korea University

How serious is the Imbalance?

- Ten East Asian countries have been running sizable amounts of surplus on their current accounts, the bulk of which have been sterilized and added to their reserves.
- A large portion of East Asia's current account surpluses has come from the region's trade with US, and not surprisingly has been converted into its holdings of short-term US treasury securities.
- Is this trans-pacific imbalance a serious concern? Could it undermine stability of US and international financial markets?
- The purpose of this paper is to analyze the causes and consequences of the transpacific imbalance.

II. Rationale for Intervention in the Currency Market and Reserve Accumulation

- **II-1. Collapse of the Investment Demand**
- Current account surpluses have brought about a substantial increase in net capital inflows as they are viewed in the eyes of foreign investors an improvement in economic fundamentals.
- The subsequent increase in the supply of money has sparked off an ominous real estate boom in countries such as China and Korea and has been building up inflationary expectations.
- These problems are serious and could even precipitate another round of a financial crisis as the rigid exchange rate policy could rekindle a real asset boom.

- Yet, East Asian policy makers have shown little indication that they would make any macroeconomic policy adjustments soon.
- Why are they so complacent?
- From their point of view, the current account surpluses and reserve accumulations are the consequences of the 1997-98 crisis that have curtailed investment demand.
- Immediately after the crisis, exports provided the only way out of the crisis and of sustaining recovery, as they were not able to implement expansionary monetary and fiscal policy to expand domestic demand.

- Most East Asian countries have also had to generate current account surpluses to replenish their reserves they lost in the run-up to the crisis.
- Unable to stimulate domestic demand, East Asian countries have been driven to rely on exports to sustain a fledgling recovery.
- Since most East Asian countries had benefited from an export-led growth strategy before the crisis, it was natural that they turned to exports as the major source of growth.

II-2. Conflict between Export-led Growth and Free Floating

- Immediately after the crisis, the crisis-hit countries except for Malaysia had to embrace a more flexible exchange rate system.
- A greater exchange rate flexibility together with capital account deregulation increased volatility of the nominal exchange rate.
- The volatility increase in turn made it difficult to maintain competitiveness of East Asia and hence to promote the export-led growth strategy.

- Such an open economy regime may not be consistent with the export-led growth strategy.
- In a free floating and deregulated capital account regime, determination of the nominal exchange rate will be dominated by capital account transactions, irrespective of developments in the current account.
- The nominal exchange rate that is driven by the capital account may not help keep export competitiveness of these countries vis-à-vis their competitors.
- At this stage of development, few East Asian emerging market economies are prepared to give up their reliance on exports for growth and development.

- However, the export-led growth strategy presented the best hopes of reaching the development goal.
- This growth objective and the fact that most East Asian countries have not reached the stage where they can open fully their financial markets have provided the rationale for their intervention in the foreign exchange market.
- This intervention is reflected in remarkable stability of the real effective exchange rates of East Asian countries except for Indonesia in recent years (see JP Morgan data in Figure 1).

II-3. Limited Scope of Financial Deregulation

- Staying with a flexible exchange rate system has been also hampered by the slow progress in financial market deregulation and opening.
- Difficulties in reforming domestic financial institutions and markets have left these countries as vulnerable to external financial shocks including speculative attacks and have made them reluctant to let their exchange rates float.
- Sensing the vulnerability, they have instead taken refuge in large reserves amassed for a war chest for warding off future crises.

III. Realignment of East Asian Currencies: Collective Action Problem

- Now with large amounts of reserves, and the fear of another financial crisis diminished, one would expect that these countries would be inclined to intervene less frequently than before to let their dollar exchange rates appreciate.
- However, East Asian policymakers have not restrained themselves from market intervention.
- As a result, the current policy regime will trigger a painful adjustment which will result in real appreciation of East Asian currencies, possibly igniting a real estate boom, raising inflationary expectations, and eventually curbing further increase in their current account surpluses.

- The main cause of this policy paralysis can be traced to the collective action problem in East Asia.
- Clearly there is a need for a collective exchange rate policy for the entire region as in the ASEAN+3 meetings of finance ministers or their deputies.
- However, if the past experience with policy coordination among ASEAN+3 is any guide, the thirteen countries will not be able to agree on any issue as complicate as the realignment of the regional currencies vis-à-vis the dollar.

- This difficulty in policy coordination can be attributed to the following two structural problems.
- First, Japan and China, the two major countries that should provide leadership for any collective policy actions, have not seen eye to eye on many regional issues, largely because of a rivalry for a greater economic and political clout in East Asia between them.
- Second, the thirteen countries will not be able to agree on the extent of appreciation each country is willing to accept, even when they could in principle agree to a readjustment of their currencies.

IV. Effects of Policy Adjustments in East Asia on the Transpacific Imbalance

- The demand for an appreciation of all regional currencies in East Asia raises two fundamental questions.
- One is the collective action problem. Another issue is the extent to which an across the broad appreciation of East Asian currencies will reduce the transpacific imbalance.
- This question is an empirical one, and simulation exercises of quantifying the effects of changes in East Asia's policy variables on its surplus suggest that these policy changes will not be very effective (Lee, McKibbin, and Park 2004).

- Preliminary results, using a CGE model developed by McKibbin, show that the across the board exchange rate adjustment in East Asia has little or no effect on current account movements of individual East Asian countries.
- Fiscal expansion in East Asia except for Japan tends to increase Japan's surplus vis-à-vis the rest of East Asia.
- The major finding of this simulation exercise is that unless the U.S. takes measures to deal with its current account deficit, East Asia alone cannot restrain the expansion of, let alone reducing, the transpacific imbalance.

V. A long Term Solution: Trade and Financial Integration in East Asia

- If both the U.S. and East Asia fail to make policy adjustments needed to bring the imbalance under control, what will happen?
- A painful domestic adjustment will eventually run its course to cause real appreciation of East Asia's currencies. This may lead to a bad equilibrium as it did during the 1997-98 crisis.
- What are then long-term solutions to the transpacific imbalance?

- First, Financial Liberalization
- Resurrection of the reform of the international financial system will help prevent future financial crises and ease the adjustment burden of East Asia's financial market opening.
- If it is not feasible at this stage, the second best solution, as far as the G-7 is concerned, is to support the ongoing regional movement for financial integration in East Asia.
- Deeper integration of regional financial markets may then push East Asian countries to either free floating or forming a region wide collective exchange rate system as it did in Europe.

- Second, Trade Liberalization

- The G-7 countries could also encourage and support in any way they can to help East Asian economies liberalize further their trade regimes.

- Trade integration is then expected to create pressure for stable currencies in the region, which will in turn generate incentives for cooperation for developing a collective exchange rate system for the region. (Bergsten and Park, 2002)

- Third, Creating Regional Bond Markets.

- This development will help East Asian countries move into a higher gear for regional financial integration.

- This development could loosen up East Asia's pegging to the dollar and reduce region's investment in US short-term Treasury securities.

VI. Concluding Remarks

- Macroeconomic adjustments in East Asia is inevitable.
- Unilateral policy changes in East Asia will not stop the swelling of the transpacific imbalance.
- In the absence of policy cooperation between the US and East Asia, the transpacific imbalance will eventually work itself out through a protracted process of real appreciation of the East Asian currencies.
- In the end East Asia’s import demand will increase, but it is uncertain whether it will be met by US exporters.